Nos. 21834 and 21834-A

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

WEYERHAEUSER COMPANY,
Appellant

v.

UNITED STATES OF AMERICA,
Appellee

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Appellant

v.

WEYERHAEUSER COMPANY,
Appellee

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON

BRIEF FOR THE UNITED STATES AS APPELLEE AND BRIEF FOR THE UNITED STATES AS APPELLANT

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OPINION BELOW

The District Court's memorandum orders dismissing action (R. 14-15) and denying reconsideration (R. 17-18) and the findings of fact and conclusions of law (R. 19-37) are not officially reported.

JURISDICTION

This appeal involves federal income taxes. The taxes in dispute for the years 1954, 1955, 1956 and 1957 were paid as follows: $16,324.88, plus interest of $4,159.04 on November 9, 1962, and $439,077.68, plus interest of $181,727.78 on November 4, 1963. (R. 20.)

Claims for refund were filed on May 27, 1964, and were rejected on October 2, 1964. (R. 20.) Within the time provided in Section 6532 of the Internal Revenue Code of 1954, on June 3, 1965, taxpayer brought this action in the District Court for the recovery of the taxes paid. (R. 20.) Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1346. The District Court's pretrial order identified two issues labeled therein "First Question Presented" and "Second Question Presented". (R. 3-9.) The two questions were unrelated factually and legally. The District Court determined the "First Question" for the taxpayer and the "Second Question" for the Government. (R. 22, 36.) The judgment of the District Court for the taxpayer in the amount of $257,957.70 was entered on December 21, 1966. (R. 38-39.) Within sixty days thereafter, on February 16, 1967, notice of appeal was filed by the taxpayer. (R. 41.) On the same day the United States filed a notice of appeal. (R. 40.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

Because of the distinct nature of the issues each will be discussed in a separate brief under the same cover.

QUESTION PRESENTED

Whether taxpayer "owns" or "has a contract right to cut" one-half of the timber growing on the

land of the Scott Paper Company[1] so as to be entitled under the provision of Section 631(a) of the Internal Revenue Code of 1954, to treat the cutting of that timber as a sale or exchange thereof.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the statutes and Regulations involved are set out in Appendix A, *infra.*

STATEMENT

The Government accepts the facts as stated in taxpayer's brief (pp. 3-12) except that the Government does not concede that taxpayer had any property interest in Scott's timber before it was cut. (Compare Taxpayer's Br. 5, 9, 10, 11.) This is essentially the issue to be decided by the Court of Appeals.

SUMMARY OF ARGUMENT

To qualify to elect "sale or exchange" treatment for appreciation to timber, Section 631 of the Internal Revenue Code of 1954 requires that a taxpayer be the owner or have a "contract right to cut, such timber." The contractual relations here provided for the pooling of logs and forest products to be harvested by a third party from the timber owned by the taxpayer and

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[1] Scott Paper Company is the successor in interest to the Soundview Pulp Company. (R. 22.) Both companies will be referred to as "Scott".

Scott. Such pooling of logs and forest products does not qualify under Section 631. An analysis of the contracts clearly shows that taxpayer was never the owner, nor had a contract right to cut Scott's timber.

ARGUMENT

THE TAXPAYER IS NOT ENTITLED TO THE BENEFITS OF SECTION 631 SINCE IT WAS NEITHER THE OWNER OF, NOR HAD A CONTRACT RIGHT TO CUT, TIMBER ON SCOTT'S LAND

To qualify for its benefits, Section 631(a) of the Internal Revenue Code of 1954 (Appendix, *infra*) requires that a taxpayer own or have a "contract right to cut, such timber." There is no dispute that Scott, not the taxpayer, was the owner of the timber on Scott's land. In fact in the agreements of January 21, 1946 between taxpayer and Soundview (Scott's predecessor), and taxpayer, Soundview and Mountain Tree Farm Company, it was expressly provided that each of the parties would remain the owner of its own timber. (R. 25, 27, 29; Exs. 2, 3.)

Taxpayer, however, misconstrues the purpose of the 1946 agreements (R. 23-34; Exs. 2, 3), and the contractual relationships of the parties ensuing therefrom. The agreements did not, as taxpayer contends (B4. 22-27), grant to each party a legal right to cut

any timber of the other but instead provided for joint logging operations, a pooling of "all logs and other forest products," and delivery of one-half thereof to each party (R. 23). Nowhere in the forty-two pages comprising the three agreements does there appear any language purporting to give the taxpayer a right itself to enter on Scott's land and cut timber, although they were executed three years after the provision here in issue was enacted into the tax law in 1943 by adding Section 117(k) to the Internal Revenue Code of 1939, the predecessor of Section 631 of the 1954 Code. 3B Mertens, Law of Federal Income Taxation (Rev.), Section 22.128. If the taxpayer had so intended it could easily have drafted the agreements so as clearly to avail itself of the tax benefits of this section of the Code. Further more, under the law of the State of Washington, which definitely distinguishes between standing timber as realty, and cut logs as personalty, the proper way to grant an interest in timber, or right to cut, is by formal deed, not in contractual instruments such as are involved here. In *Coleman* v. *Layman*, 41 Wash. 2d 753, 252 P. 2d 244, the court said, at page 756.

> Growing timber can be conveyed separately from the land on which it grows. Such a conveyance, with the right to enter upon the land and remove the timber in the future, either within a stated or a reasonable time, is the conveyance of an in-

> terest in realty and is *properly done by deed.* See *Elmonte Inv. Co.* v. *Schafer Bros. Logging Co.*, 192 Wash. 1, 22 72 P. (2d) 311 (1937), and cases cited. (Emphasis added.)

In accord: *Groenveld* v. *Dean*, 40 Wash. 2d 109, 241 P. 2d 443. If the parties, two of the largest holders of timber in the Seattle Watershed (R. 22), had intended to convey interests in timber it seems that they would have used documents proper for that purpose.

Actually there was no reason to exchange interests in timber. The parties contracted because of the insistence of the City of Seattle that their logging operations be contracted jointly. This was accomplished through the use of a single logger for both parties, and equal division of the logs and forest products harvested between them. The right of the logging company which performed the joint logging operation to enter upon the respective lands of Scott and the taxpayer and to cut timber therein was conferred upon it by the respective owners of those lands. The equal division made necessary the provisions for payments to compensate for any imbalance in logs and forest products taken from the timber of the two parties. No actual rights in the standing timber of each other was needed.

In the 1946 agreements the parties expressly stated their purpose to be to deliver one-half of the logs

and other forest products to each of the parties. The Agreement between the taxpayer and Scott of January 21, 1946 states (R. 24; Ex. 2):

> It is the desire of the parties hereto that their agreements concerning the prices to be charged and paid *for logs and other forest products* delivered to one party from the timber of the other, and their other agreements with respect to the logging, delivery and payment of and *for logs and other forest products* to be removed *from their respective tracts of timber* be set forth at length. (Emphasis added.)

That the parties contracted for delivered cut logs and forest products, not with respect to interests in standing timber, is further supported by the parties' own characterization of their logging contract with Mountain Tree, the "Operator" (R. 23; Ex. 2):

> * * * whereby the parties hereto have agreed that the Operator shall, and it has agreed to cut and remove so much of said *timber of each of the parties* * * * and whereby the Operator shall and will deliver one-half of all *logs and other forest products* so removed to each of the parties hereto." (Emphasis added.)

The logs were to be transported by the operator to the log dump of a designated boom company where they were to be sorted, rafted and scaled, after which they were to be delivered to the parties. The other forest products were to be delivered by the operator to points specified by each company. (R. 33-34; Ex. 3.)

Clearly the sale of interests in the standing timber was not intended. The agreements are quite specific in referring to "timber" when they mean the forest growth from which marketable forest products can be produced, and to "sawlogs", "pulp wood", and "other forest products" when referring to the material produced in the harvesting operation. (R. 29-30; Ex. 3.) It was the latter for which the parties contracted.

The substantial incidents of ownership which each party retained in its own timber are at odds with a transfer of a proprietary interest to the other party (cf. Taxpayer's Br. 15-22):

1. Each party retains title to its own timber and the logs until delivered. (R. 25; Ex. 2.) After cutting the logs were branded with the mark of the timber owner which evidenced its continued ownership. (R. 33; Ex. 3.) Cf. *State* v. *Tullock*, 118 Wash. 496, 203 Pac. 932. Title did not pass until the logs were actually delivered to the respective parties.

2. Each party retained the risk of damage and of destruction of its own timber by fire or other causes. If any timber were so destroyed, or taken by eminent domain, the owner of the timber was permitted to recover and retain the proceeds and compensation "free from any claim of the other party thereto." (R. 28; Ex. 2.)

3. Each party was to pay the property taxes and charges for fire protection on its own timber except that after 1970, by which year taxpayer's timber was to be completely removed, taxpayer agreed to pay one-half of the taxes and charges in Scott's remaining timber. (Ex. 2, pp. 3-4, par. I(b).)

The joint ownership and control of the logging company, Mountain Tree, by taxpayer and Scott was necessary for the joint logging operation, and for the pooling and equal division of the cut logs and forest products between the parties. It does not establish that Mountain Tree was exercising a cutting right of the taxpayer when it cut Scott's timber. (Cf. Taxpayer's Br. 22-27.)

In fact the logging contract expressly negates that Mountain Tree was the agent for either party. The right to cut the entire watershed timber was vested exclusively in Mountain Tree and neither taxpayer nor Scott retained such rights.[2] (R. 30-32; Ex. 3, pp. 15-16, par. VI.)

In the context of the three agreements (Exs. 1, 2, 3) the provisions in Article II(b) of the contract between taxpayer and Scott for specified "stumpage"

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[2] Of course Mountain Tree, the logger, was not given a "contract right to cut" qualifying it for Section 631 benefits since it had no unlimited right to dispose of the cut timber. Cf. *Carlen* v. *Commissioner*, 220 F. 2d 338 (C.A. 9th); *United States* v. *Johnson*, 257 F 2d 530 (C.A. 9th).

payments for logs were not made for timber. (R. 25-26; Ex. 2). These payments were required to equalize the contribution of each party to the cost of logs produced from the timber of both companies. It was not a payment for any specific quantity of timber. It was needed because the values of the logs vary by species and location. A payment would be required, for example, if equal quantities of logs were cut and delivered from the timber of each company but the value, at the agreed prices, produced from Scott's timber exceeded that produced from taxpayer's. It is noted that for hemlock pulpwood the agreed price is expressed fifty cents "per cord of 128 cubic feet" indicating that the payments were for "cut wood." (R. 25-26; Ex. 2.)

Taxpayer's principal contention (Br. 14-22) appears to be that since taxpayer, by reason of the 1946 agreements, obtained the benefits of the appreciation in value of Scott's timber after that date it should be allowed the benefits of Section 631 of the Internal Revenue Code. As we have shown, taxpayer does not qualify under Section 631. It should, more fittingly, address its complaint to Congress in a request for legislative correction than to seek, as it does here, to have this Court misapply the existing statute to the facts in this case.

Under the 1946 agreements all taxpayer had, as

we have shown, was a right to the delivery of one-half of the logs produced from Scott's timber in exchange for one-half of the logs produced from its own timber, plus equalization payments for any excess from either. The fact that the agreements ultimately enabled it to profit from appreciation in Scott's timber gave it no proprietary interest in the timber itself. The same advantage would equally result from any long-term contract for the purchase of logs at a fixed price. Surely the taxpayer would not contend that, e.g., a paper manufacturer on the East Coast who had in 1946 contracted with Scott for the delivery to it there in a later year, but at a fixed price, of a quantity of logs, or other forest products, after having been cut by Scott from timber on Scott's land in Washington, would be entitled to the benefits of Section 631, merely because the value and going price of such logs, etc. had increased in the interim. The taxpayer is in no different position. Its error is in seeking to make the fact that it stood to gain from an increase in the value of the logs, etc., which it might receive under the contracts the sole determinant of eligibility under Section 631,[3]

[3] In making it necessary, in order that a taxpayer qualify under the statutory term "contract to cut," that the taxpayer have the right to cut timber for its own account, or to use the cut timber in its own business, Treasury Regulations on Income Tax (1954 Code), Sec. 1.631-1(b)(1), and the decisions of this court in *Carlen* v. *Commissioner,* 220 F. 2d 338, and *United States* v. *Johnson,* 257 F 2d 530, do not purport to void the primary requirement that taxpayer actually have the prerequisite contract right to enter and cut the timber in question nor to extend the statute so as to cover those who have merely a right to receive logs at a contract price less than the market rate at the time of delivery.

while ignoring the fact that the statute clearly limits those benefits to those who occupy the legal status of owner, or who have a "contract right to enter and cut".

The judgment of the District Court should be affirmed as to the Section 631 issue.

No. 21,834-A

IN THE

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UNITED STATES OF AMERICA,
Appellant

v.

WEYERHAEUSER COMPANY,
Appellee

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON

BRIEF FOR THE UNITED STATES AS APPELLANT [1]

QUESTION PRESENTED

Whether the taxpayer is required to set off casualty losses against gains subject to Section 1231 of the Internal Revenue Code of 1954, or may deduct them as ordinary losses under Section 165 of the Code.

STATUTE AND REGULATIONS INVOLVED

The statute and Regulations involved are set forth in the Appendix, *infra*.

[1] The "Opinion Below" and "Jurisdiction" are the same as in the Brief For The United States as Appellee, *supra*.

STATEMENT

During the years 1954, 1955, 1956 and 1957, taxpayer suffered certain losses of property. The losses included destruction of timber, plant facilities, machinery, equipment and offices, all of which had been held for appropriate utilization in the taxpayer's business for more than six months. They were variously caused by fire, storms, blasts, beetles and hurricanes. The amounts of the losses were as follows (R. 21):

Year	*Amount of Loss*
1954	$185,903.28
1955	164,066.05
1956	131,716.00
1957	195,225.00

The losses were not insured. Taxpayer took the position on its returns and claims for refund that they were deductible from ordinary income under Section 165 of the Internal Revenue Code of 1954. On audit of taxpayer's returns, the Internal Revenue Service took the position that the losses were subject to Section 1231 (a) of the 1954 code and, therefore, because taxpayer's gains subject to Section 1231(a) exceeded its losses subject to that section (exclusive of the aforesaid casualty losses) by amounts greater than the sum of the casualty losses for each of the years in issue (R. 21-

22), were deductible only as capital losses, as provided in Section 1231(a).

The District Court concluded that the taxpayer is not required to apply the losses in question to gains subject to Section 1231 of the 1954 Code but may deduct the losses as ordinary losses under Section 165. (R. 22.)

SPECIFICATION OF ERROR RELIED UPON

The District Court erred in concluding that taxpayer's uninsured casualty losses need not be applied against Section 1231 gains under Section 1231 of the Internal Revenue Code of 1954, but may be deducted as ordinary losses under Section 165 of the Code.

SUMMARY OF ARGUMENT

By reason of the definition contained in subsection (2) of Section 1231(a) of the Internal Revenue Code of 1954, all casualty losses incurred by a taxpayer during years prior to 1958 are treated as involuntary conversions which by that section of the statute are required to be set off against capital gains. This construction of the statute is consistent with the expressed understanding of Congress which, in 1958, amended the law for subsequent years, and longstanding Treasury Regulations. It has been approved by three courts of appeals. *Morrison* v. *United States*, 355

F. 2d 218 (C.A. 6th), certiorari denied, 384 U.S. 986; *Chewning* v. *Commissioner*, 363 F. 2d 441 (C.A. 4th), certiorari denied, 385 U.S. 930; *Campbell* v. *Waggoner*, 370 F. 2d 157 (C.A. 5th). The only appellate authority to the contrary is the decision in *Maurer* v. *United States*, 284 F. 2d 122 (C.A. 10th), the demonstrable errors of which stem from a fundamental misconception of (1) the relationship between Section 165 allowing the deduction of casualty losses and Section 1231 which requires, as a matter of computation, that such losses be set off against Section 1231 gains for the years prior to 1958, and (2) a refusal to give effect to the mandate of the statute that a loss from destruction (casualty) be deemed an involuntary conversion.

ARGUMENT

TAXPAYER'S UNINSURED CASUALTY LOSSES MUST BE OFFSET AGAINST ITS GAINS AS PROVIDED IN SECTION 1231 OF THE INTERNAL REVENUE CODE OF 1954.

A. *The statute and authorities require the offsetting*

In holding that taxpayer's wholly uninsured casualty losses, incurred to its timber, and other business property, prior to 1958, were deductible in full and need not be set off against taxpayer's Section 1231 gains (R. 22), the District Court did not follow the requirement of Section 1231(a) of the Internal Revenue

Code of 1954 (Appendix, *infra*). This statute constitutes in substance a provision that where gains on sales or exchanges of property used in trade or business, plus gains from involuntary conversions of property used in trade or business and capital assets held for more than six months exceed the recognized losses from such sales, exchanges and conversions, then these gains and losses are to be treated as though they were gains and losses from sales or exchanges of capital assets held for more than six months. In such event, the losses are not treated as ordinary losses, but serve to reduce the amount of capital gains. On the other hand, the statute further provides, if such gains do not exceed such losses (i.e., from sales, involuntary conversions, etc., of capital assets), such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets; i.e., the gains are treated as ordinary income and the losses are allowed as ordinary losses.

Especially pertinent to the present case involving wholly uninsured losses is the provision of Section 1231 (a)(2) that losses upon the destruction, in whole or in part, of property used in the trade or business shall be considered losses from an involuntary conversion to which the netting provisions of the statute apply. This subsection provides:

> (2) losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

This subsection (2) completely refutes any contention taxpayer may make that Section 1231(a) does not apply here on the ground that the uninsured losses were not converted into other property and were not "involuntary conversions" within the intendment of that statute. Congress clearly directed that for the purpose of application of Section 1231(a) and in determining whether or not gains exceed losses, or vice versa, losses upon destruction of property used in the trade or business or capital assets held for more than six months should be considered losses from a compulsory or involuntary conversion both when the property is converted into other money or property (as in the case of insurance), or whether, as here, no compensation is received for the losses. It is evident from the express definition of Section 1231(a)(2) that where a loss is sustained, when property used in the trade or business or a capital asset is destroyed in such manner as to be deductible loss under Section 165(a) (Appendix, *infra*), it is to receive the same treatment as would a similar loss if compensation were made in part from insurance or some other source.

Moreover, the legislative history of Section 1231 (a) in years subsequent to the tax years 1954 through 1957, here involved, strongly evidences that the District Court's construction of Section 1231 is correct and that casualty losses upon destruction of property are to be taken into consideration under the terms of that statute as a compulsory or involuntary conversion even though the taxpayer is not compensated by insurance in any amount. Section 49(a) of the Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606, effective for years after December 31, 1957, added the following sentence at the end of Section 1231(a):

> In the case of any property used in the trade or business and of any capital asset held for more than 6 months and held for the production of income, this subsection shall not apply to any loss, in respect of which the taxpayer *is not compensated for by insurance in any amount*, arising from fire, storm, shipwreck, or other casualty, or from theft. (Emphasis added.)

Plainly this amendment would have been completely unnecessary if taxpayer's contentions were correct. Congress could have regarded the amendment as necessary only because it interpreted Section 1231, as it existed before amendment, to require the inclusion of otherwise covered losses under Section 1231 even though not compensated by insurance in any amount. Indeed, this interpretation is specifically expressed in

the report of the Senate Committee on Finance, which recommended the enactment of the amendment (S. Rep. No. 1983, 85th Cong., 2d Sess., pp. 74-75, 203-204 (1958-3 Cum. Bull. 922, 995-996, 1124-1125)):

> Under present law *where there are uninsured losses on property* as a result of its destruction, theft, seizure, requisition, or condemnation, such losses, in the case of property used in the trade or business or capital assets held for more than 6 months, are treated as section 1231 losses. * * *
>
> Where a taxpayer elects to be a self-insurer against casualty losses, *there seldom is a conversion into money or other property*, as there would be if the destroyed property were insured. If this casualty loss were the only loss incurred during the taxable year by the self-insured person he would be entitled to the full benefit of an ordinary loss deduction under section 1231, but where there are also 1231 gains, the casualty loss is partially or wholly offset against these gains which would otherwise be taxed as capital gains. * * *
>
> Under section 1231, *uninsured casualty losses on* depreciable property or real estate used in the trade or business or on capital assets must be *aggregated with various other types of section 1231 gains and losses.* * * * (Emphasis added.)

In addition to the above considerations, the applicable Treasury Regulations on Income Tax (1954 Code), Section 1.1231-1(e) (Appendix, *infra*), provide explicit supporting authority for the Government's position. Prior to the 1958 amendment to the statute,

the pertinent portion of the regulations read as follows (T.D. 6253, 1957-2 Cum. Bull. 547, 551);[2]

> (e) *Involuntary conversion.*—For purposes of section 1231, the terms "compulsory or involuntary conversion" and "involuntary conversion" of property mean the conversion of property into money or other property as a result of complete or partial destruction, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof. Losses upon the complete or partial destruction, theft, seizure, requisition or condemnation of property are treated as losses upon an involuntary conversion *whether or not there is a conversion of the property into other property or money.* For example, if a capital asset held for more than 6 months, with an adjusted basis of $400, is stolen, and the loss is not compensated for by insurance or otherwise, section 1231 applies to the $400 loss. (Emphasis added.)

As seen, its exposition of the coverage of the statute is precisely that stated by the Senate Committee in its 1958 report, *supra.* Moreover, this same application of the law was embodied in the prior Regulations under the 1939 Code,[3] this being the consistent posture of the Regulations back as far as 1943,[4] the year after the initial 1942 enactment of the statutory provision. This

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[2] Although issued in 1957, these Regulations were expressly made effective for years beginning after December 31, 1953.

[3] Treasury Regulations 103 (1939 Code), Section 19.117-7; Treasury Regulations 111 (1939 Code), Section 29.117-7; Treasury Regulations 118 (1939 Code), Secion 39.117 (j)-1(a)(2).

[4] See Treasury Regulations 103 (1939 Code), Section 19.117-7, as added by T.D. 5217, 1943 Cum. Bull. 314.

long-standing and consistent position, which has weathered the passage of 26 years, three amendments to Section 117(j) of the 1939 Code,[5] and the re-enactment of Section 117(j) of the 1939 Code as Section 1231 of the 1954 Code and which was ratified by the Congress, for years prior to 1958, in both the statutory language of the 1958 amendment, made effective only for later years, and the supporting Committee Report, takes on the character of established law. As stated by the Supreme Court in *Lykes* v. *United States*, 343 U.S. 118, 127:

> Such a regulation is entitled to substantial weight [citing cases]. Since the publication of that Treasury Decision, Congress has made many amendments to the Internal Revenue Code without revising this administrative interpretation of Section 23(a) (2) [citing cases].

And, in *Helvering* v. *Winmill*, 305 U.S. 79, 83, it said:

> Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.

In accord: *United States* v. *Correll*, decided December 11, 1967 (36 U.S. Law Week 4055).

It should be noted that the Congress not only re-

[5] See Section 127(b), Revenue Act of 1943, c. 63, 58 Stat. 21; Section 210(b), Revenue Act of 1950, c. 994, 64 Stat. 906; Sections 322(c)(3), 323(a)(1), 324 and 325(a), Revenue Act of 1951, c. 521, 65 Stat. 452.

enacted the statute without change in the 1954 Code but in making the 1958 amendment which, for years thereafter, provided a different treatment of wholly uninsured losses to business property, expressly recognized and construed the pre-amendment version of Section 1231(a) as including such losses and as requiring amendment in order that they be excluded for subsequent years. Pursuant to that statutory amendment, the Treasury Department amended Section 1.1231-1 (e) of its Regulations (by T.D. 6394, 1959-2 Cum. Bull. 186) so as to give effect to the special exclusion from coverage under Section 1231 of uninsured casualty losses, *incurred in years ending after 1957*, to property used in the business or held for the production of income, but, consistently with the provision of the statute, and the flat statements of the supporting Committee Report, retaining the inclusion of uninsured losses to such assets in prior years, such as those before the Court. Surely, the law could not be more clearly or authoritatively established.

The Government's position that all casualty losses in years prior to 1958 must be set off against Section 1231 gains, irrespective of whether the assets were insured or not, has been accepted by three federal courts of appeal. *Morrison* v. *United States*, 355 F. 2d

218 (C.A. 6th), certiorari denied, 384 U.S. 985;[6] *Chewning* v. *Commissioner*, 363 F. 2d 441 (C.A. 4th), certiorari denied, 385 U.S. 930; *Campbell* v. *Waggoner*, 370 F. 2d 157 (C.A. 5th). Although these cases involved years subject to the 1958 amendment (Section 49, Technical Amendments Act of 1958, Appendix, *infra*), that amendment was not applicable to the fact situations there since the assets involved were nonbusiness and personal. The instant taxpayer can prevail only on the theory that all wholly uninsured losses were excluded from the pre-amendment statute (which made no distinction between business and personal assets). The answer to that question necessarily controlled the issue before the Fourth, Fifth and Sixth Circuits in the cited cases since the tax treatment of losses to personal assets (there in issue) was not changed by the amendment. Accordingly the decisions are authoritative as to the construction of Section 1231 (on the point relied on by taxpayer) in the pre-amendment years involved in this case. Each of the three cited opinions disapproved of the sole appellate case which may be relied upon by the taxpayer and whose errors will be discussed *infra*, *Maurer* v. *United States*, 284 F. 2d 122 (C.A. 10th). The taxpayer may also cite the unappeal-

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6 Following *Morrison*, the Court of Appeals in the Sixth Circuit also reversed two lower court decisions based on *Maurer*, discussed in text: *Killebrew* v. *United States*, decided August 3, 1966 (18 A.F.T.R. 2d 5572), and *Hall* v. *United States*, decided August 3, 1966 (18 A.F.T.R. 2d 5572).

ed district court opinion in *Oppenheimer* v. *United States*, 220 F. Supp. 194 (W.D. Mo.) which, without independent analysis, merely followed *Maurer* on the stated belief that it was bound thereby.

In successfully opposing petitions for certiorari by the taxpayers in *Morrison* (No. 1241, October Term, 1965), and *Chewning* (No. 478, October Term, 1966) cases, the Government pointed out that the language of the statute as amended in 1958 (and involved in those cases) was materially different than that prior to the amendment (as involved in *Maurer* and the instant case) and that, therefore, regardless of what the pre-amendment law had covered, it was not necessary for the Supreme Court to resolve any possible conflict with *Maurer* since in each case before it was the post-amendment statute that concededly governed and there was no conflict as to the meaning and coverage of the amended statute.

It was also of importance that, with respect to future litigation, only the proper construction of the post-1958 statute would be of continuing significance since there could be only a few isolated cases still open which would come under the pre-amendment statute. Since there was no question, and uniform agreement of the appellate courts, that Congress had clearly provided in the amended statute, and in the accompanying

Committee Reports, *supra*, that wholly uninsured casualty losses to personal property in years covered by the amendment were included in the Section 1231 computation, consideration of the apparent conflict between *Maurer* and the other decisions could determine only whether *Maurer* had correctly construed pre-amendment law—i.e., whether (1) had the effect of excluding the amendment of uninsured losses to business properties which had theretofore been included in the pre-1958 law (as the Government contended), or (2) as would be the case if *Maurer* was correctly decided, it had included uninsured losses to personal property which had theretofore been excluded.

In the instant case, involving pre-amendment law, it becomes necessary to resolve that conflict in order for this court to reach the correct result. In this connection, we point out, in addition to the clear expressed view of the Fourth, Fifth and Sixth Circuits that *Maurer* had erred as to the coverage of Section 1231, the following two significant considerations:

1. The language of the pre-amendment statute upon which the advocates of the *Maurer* result solely rely ("into other property or money") appears unchanged in any way in the amended statute. It cannot be reasonably said to exclude uninsured lossess from the former while not having that effect in the latter.

2. As previously noted, the pertinent Treasury Regulations clearly provide for the result here urged by the Government. They must be given effect unless it be deemed that they are invalid because in conflict with the clear intent of the statute. This, in turn, can only be the case if this Court is able to conclude that inclusion of the phrase in question (into other property or money) leaves no possible construction other than an intended exclusion of wholly uninsured losses. Yet, it must be noted that the Congress which enacted the 1958 amendment did not feel that, in order to accomplish their expressed purpose of *including* uninsured losses to personal property under Section 1231, it was necessary to eliminate that phrase. Consequently, it can scarcely be said that no Congress could regard that language as failing to exclude wholly uninsured losses. For that reason, we submit, the Regulations are clearly valid.

B. *The Maurer opinion was erroneous*

As noted the taxpayer may rely on *Maurer* v. *United States, supra,* the rationale of which has been uniformly rejected by three other courts of appeal. *Morrison* v. *United States, supra; Chewning* v. *Commissioner, supra; Campbell* v. *Waggoner, supra. Maurer* was a completely erroneous decision, not only because of the Tenth Circuit's failure to consider the

Congressional views reflected in the significant 1958 developments, but because of the chain of other basic errors and *non sequiturs* upon which that decision rested (which were pointed out to the appellate courts which have expressed disagreement with *Maurer*), and which we will now discuss in the order in which they appear in that opinion.

The Tenth Circuit (p. 123) commenced its discussion by expressing the view that Sections 165 and 1231 are mutually exclusive. This is incorrect and the court's misunderstanding led to subsequent errors (see *infra*). First, Section 1231 does not include in gross income any receipts which do not have that status by force of other provisions of the statute, nor does it make deductible any losses which are not already deductible under other sections. This is expressly stated in Section 1231(a)(1), which provides that gains shall be included in the computation only to the extent taken into account in computing gross income and losses only to the extent taken into account in computing taxable income. See also Treasury Regulations on Income Tax (1954 Code), Section 1.1231-1 (d) and (g), Example 3 (Appendix, *infra*). Section 1231 merely provides special additional benefits in the form of reduced tax rates (capital gain rates) for certain items of income—namely, the proceeds of sales or exchanges of business

property and of the involuntary conversion of business property or of capital assets held for more than six months (providing, of course, they exceed the losses from such sources). It will be noted that Section 1231 specifies only that if gains of the specified types exceed losses they "shall be considered as gains or losses from sales or exchanges of capital assets held for more than six months," whereas if the losses are the greater "such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets." Thus, this section purports to do no more than determine whether the specified types of gains or losses (here, casualty losses to business property) shall be deemed capital in nature, or ordinary. In order to be *deductible* (whether at capital or ordinary rates) they must first be made so by Section 165. Section 1231 does not, in actuality, convert any losses to capital losses but merely uses those defined in Section 1231 as a measure of the amount of Section 1231 gains which do not need, and should not be given, the special relief treatment as capital gains. Thus, there is no conflict between Section 165 and Section 1231, and inclusion of casualty losses in the Section 1231 computation does not take them out of the coverage of Section 165. They are included in the Section 1231 computation only *because* they are allowable as deductions under Section 165.

2. After recounting with substantial accuracy the historical purpose of Section 1231 and the fact that it provides capital gain treatment for net gains and ordinary loss treatment for net losses, the court observed (p. 124) that "Viewed in this light" it was clear that Section 1231 was aimed at compensated losses, with uncompensated losses left to Section 165. The predicate does not lead to that conclusion nor has any tendency to support it. Neither the exclusion nor the inclusion of uncompensated losses under Section 1231 would alter or affect in any way the recited purposes of the provision or the scheme of the netting computation, and the court's conclusion was erroneous.

3. Next, the court observed (p. 124) that, with respect to an insured property, the taxpayer is compensated by the insurer and the "loss reduced proportionately". It then concluded that "it seems to follow" that an uncompensated loss should be allowed an ordinary deduction. This, of course, is another *non sequitur* and seems to be based upon the court's unspoken but necessary assumption that a loss not reduced by insurance comes under Section 165, while one partially compensated does not. But, as shown, every casualty loss must qualify under Section 165 *before* it can qualify under Section 1231. Moreover, it is well established that the loss deductible under Section 165

is the amount of the loss *reduced by the amount of insurance received.* I.T. 4032, 1950-2 Cum. Bull. 21 (see particularly the examples given, p. 22); *Kraus* v. *Commissioner*, decided October 31, 1951 (P-H Memo T.C., par. 51,327; 3 Rabkin & Johnson, Federal Income, Gift & Estate Taxation, Section 41.03, p. 4121a). Since, therefore, both partially insured and wholly uninsured casualty losses are equally covered by Section 165, it cannot "follow" that one or the other is thereby removed from the coverage of Section 1231. We suggest that the Tenth Circuit was misled, throughout its opinion, by the reference in Section 165(a) to losses "not compensated for by insurance or otherwise." It would seem that it took this to refer to losses where there was no insurance recovery at all rather than to that *part* of the total loss which is in excess of any insurance compensation. Section 165(a) is not concerned with whether or not there is any insurance recovery but is intended simply as a measure of the amount of the loss (the uncompensated part) which is deductible.

4. The Tenth Circuit then purported (p. 124) to find support for the above *non sequitur* with the statement that Section 1231 is "contextually similar" to the sections dealing with capital gains and losses. The court did not explain what it meant by the phrase "contextually similar" and the statement, by itself,

seems without significance to the issue before it. However, in the next sentence it reveals the misdirection of its approach, saying "Thus, a compensated loss is a taxable event closely akin to a 'sale or exchange.'" However true that may be, it fails to meet the issue, for the Government did not, and does not, claim that the instant loss is covered under Section 1231 as a "sale or exchange" but as an "involuntary conversion." We are not concerned, therefore, with the relationship between *compensated* losses and sales or exchanges, but with that between a wholly *uncompensated* loss and an involuntary conversion, as that term is used in Section 1231. A positive relation between the first pair has no tendency, without more, to establish a negative relationship between the latter pair. The nearest the court came to addressing itself to the latter was in its next sentence, wherein it merely observes that where nothing is received in compensation, the "factual situation is entirely different [from a sale or exchange, presumably] and there is no rational basis for capital loss treatment." Here, again, the court's conclusion necessarily rested upon an erroneous assumption, i.e., that Section 1231 capital loss treatment may apply only where there is a sale or exchange. But a major and un-mistakable feature of Section 1231 is the clearly expressed intent to provide capital loss treatment, where the specified circumstances existed, to other

events (i.e., involuntary conversions) *in addition* to sales or exchanges,[7] and, for this purpose, to consider involuntary conversions as different from sales or exchanges.

Section 1231(a) clearly treats the two as different in scope. After naming, as *one* of the types of gains included, those from "sales or exchanges of property used in the trade or business," it specifies "*plus*" those from "the compulsory or *involuntary conversion* [into other property or money] * * * of property used in the trade or business." (Emphasis added.) Both deal with business property; the only difference in the two is that one specifies sales or exchanges while the other adds involuntary conversion into other property or money. By using the word "plus," the Congress must have intended to add something not covered by "sales or exchanges." This the Tenth Circuit ignored in making its statement that Section 1231 was "contextually similar."

That sales or exchanges and involuntary conversions may be different transactions within the provisions of Section 1231 is recognized by tax authorities. In 3B Mertens, Law of Federal Income Taxation

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[7] In this connection, we point to the many other instances in the statute where capital gain or loss treatment was specifically provided, even though there was, in fact, no sale or exchange. See discussion in *Helvering* v. *Hammel,* 311 U. S. 504, 511.

(Rev.), Section 22.125, p. 516, dealing with Section 1231, the two are discussed as different classes of dispositions. With specific reference to the question at bar, it is said (p. 517) that:

> The provisions here discussed refer to a conversion "into other property or money," although in some instances of involuntary conversion a loss may be suffered just because the conversion does not result in receipt of any quid pro quo. For purposes of the instant provisions, under the Regulations there is nonetheless a qualifying involuntary conversion in such a case.

It is further stated, on the same page, that, as to gains from involuntary conversions, capital gain treatment is provided *even though* there is no actual sale or exchange, which would otherwise (that is, without the special provisions of Section 1231) be required for capital gain treatment. In Section 22.122, pp. 509-510, it is said that:

> Another requirement for capital gain or loss treatment [other than as provided in Section 1231] is that the capital asset be disposed of in a "sale or exchange." In many instances in which there is a compulsory disposition or an "involuntary conversion" of a capital asset, as in the case of the destruction of property, there is no sale or exchange, and again, in the absence of any further provision [i.e., Section 1231], capital gain or loss treatment would not be available.

See also p. 514, stating that "The limited capital gain tax is applied, moreover, not only where there is a sale

or exchange of such assets but also where they are the subject of an involuntary conversion." And see 3 Rabkin & Johnson, *supra*, Section 43.07, p. 4359.

5. The Tenth Circuit announced (p. 124) that if the taxpayer can prove that the loss qualifies as a casualty, "it is only logical to conclude that Congress intended that there be an ordinary deduction under Section 165." Why it is logical, the court did not say and, in fact, it is the very antithesis of logic. See our discussion in 1, *supra*, and the reference in all cited authorities to the inclusion of casualty losses under Section 1231. Furthermore, this comment by the court, we submit, was directly in contradiction to everything it had said up till that point, for it had been engaged in an effort to show that insured *casualty* losses were under Section 1231, but uninsured *casualty* losses were under Section 165. Since both categories are casualties, it is manifest that that cannot be the determinant.

6. In attempting to avoid the clear provision of the long-standing Treasury Regulations, *supra*, approved and given effect by the Fourth, Fifth and Sixth Circuits in reaching an opposite conclusion as to the coverage of the pre-1958 statute, the Tenth Circuit chose (p. 124) to treat the applicable regulatory provision that involuntary conversions shall apply whether or not other money or property is received as not cover-

ing casualty losses despite the clear statement of Section 1231(a)(2), *supra*, that losses from the destruction of property (this being the very nature of a casualty loss and, certainly, the situation involved both here and in the *Maurer* case) are to be considered losses from an involuntary conversion.

The judgment of the District Court should be reversed as to the Section 1231 issue.

CONCLUSION

The cases should be remanded with instructions to dismiss the complaint in its entirety.

Respectfully submitted,

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CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: .... day of January, 1968.

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United States Attorney

APPENDIX

Internal Revenue Code of 1954:

SEC. 165. LOSSES.

(a) *General Rule.*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

* * *

(26 U.S.C. 1964 ed., Sec. 165.)

SEC. 631. GAIN OR LOSS IN THE CASE OF TIMBER OR COAL.

(a) *Election to Consider Cutting as Sale or Exchange.*—If the taxpayer so elects on his return for a taxable year, the cutting of timber (for sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns, or has a contract right to cut, such timber (providing he has owned such timber or has held such contract right for a period of more than 6 months before the beginning of such year) shall be considered as a sale or exchange of such timber cut during such year. If such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the fair market value of such timber, and the adjusted basis for depletion of such timber in the hands of the taxpayer. Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor. If a taxpayer makes an election under this subsection, such elec-

tion shall apply with respect to all timber which is owned by the taxpayer or which the taxpayer has a contract right to cut and shall be binding on the taxpayer for the taxable year for which the election is made and for all subsequent years, unless the Secretary or his delegate, on showing of undue hardship, permits the taxpayer to revoke his election; such revocation, however, shall preclude any further elections under this subsection except with the consent of the Secretary or his delegate. For purposes of this subsection and subsection (b), the term "timber" includes evergreen trees which are more than 6 years old at the time severed from the roots and are sold for ornamental purposes.

* * *

(26 U.S.C. 1964 ed., Sec. 631.)

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

(a) *General Rule.*—If during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as

gains and losses from sales or exchanges of capital assets. For purposes of this subsection.

(1) in determining under this subsection whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing taxable income, except that section 1211 shall not apply; and

(2) losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

* * *

(26 U.S.C. 1964 ed., Sec. 1231.)

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.1231-1 *Gains and losses from the sale or exchange of certain property used in the trade or business.*

* * *

(d) *Extent to which gains and losses are taken into account.* All gains and losses to which section 1231 applies must be taken into account in determining whether and to what extent the gains exceed the losses. For the purpose of this computation, the provisions of section 1211 limiting the deduction of capital losses do not apply, and no losses are excluded by that section. With that exception, gains are included in the computations under section 1231 only to the extent that they are taken into account in computing gross income,

and losses are included only to the extent that they are taken into account in computing taxable income. The following are examples of gains and losses not included in the computations under section 1231:

(1) Losses of a personal nature which are not deductible by reason of section 165 (c) or (d), such as losses from the sale of property held for personal use;

* * *

(e) *Involuntary conversion.*—(1) *General rule.* For purposes of section 1231, the terms "compulsory or involuntary conversion" and "involuntary conversion" of property mean the conversion of property into money or other property as a result of complete or partial destruction, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof. Losses upon the complete or partial destruction, theft, seizure, requisition or condemnation of property are treated as losses upon an involuntary conversion whether or not there is a conversion of the property into other property or money unless subparagraph (2) of this paragraph applies. For example, if a capital asset held for more than 6 months, with an adjusted basis of $400, but not held for the production of income, stolen, and the loss is not compensated for by insurance or otherwise, section 1231 applies to the $400 loss.

(2) *Certain uninsured losses.* Notwithstanding the provisions of subparagraph (1) of this paragraph, losses sustained during a taxable year beginning after December 31, 1957, with respect to both property used in the trade or business and any capital asset held for more than 6 months and held for the production of income, which losses

arise from fire, storm, shipwreck, or other casualty, or from theft, and which are not compensated for by insurance in any amount, are not losses to which section 1231(a) applies. Such losses shall not be taken into account in applying the provisions of this section.

* * *

(g) *Examples.* The provisions of this section may be illustrated by the following examples:

* * *

Example (3). A's yacht used for pleasure and acquired for that use in 1945 at a cost of $25,000, was requisitioned by the Government in 1957 for $15,000. A sustained no loss deductible under section 165(c) and since no loss with respect to the requisition is recognizable, the loss will not be included in the computations under section 1231.

(26 C.F.R., Sec. 1.1231-1.)